FACT SHEET

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DETERMINING HOW MUCH YOUR FAMILY CAN SPEND FOR A HOME

Don Stebbins*

Although lenders use a formula to determine how much credit they are willing to extend for the purchase of a home, this formula does not include your family's other financial goals. Most financial consultants recognize calculating a family budget as a better method for determining how much you can afford to spend for a home.

How much can be safely and comfortably spent on a home is an important decision because, for most families, building or buying a home is its biggest investment. The approach used by financial advisors identifies all current uses of your income.

Typically, lenders use these guidelines when qualifying borrowers:

1. Monthly housing expenses should not exceed 28 percent of gross monthly income. Monthly housing expenses include mortgage principal and interest, hazard insurance premium and, when applicable, homeowners' association dues.
2. Total long-term monthly debt payments, including housing expenses, should not exceed 36 percent of gross monthly income. Usually, obligations with more than six monthly payments outstanding are considered long-term debt payments.

Calculating a family budget considers your family's long-run financial goals as well as current uses of your income. Although constructing a budget is more complicated than relying on guidelines, it helps you more closely calculate the amount of money you can safely spend on housing. Using the budget approach will help you spend an amount that is not an excessive financial burden and will not prevent your family from buying the other things it wants.

A Family Budget

Because circumstances and objectives differ, each family must calculate its own budget rather than relying on an average. A typical budget is shown in Table 1. By adding or deleting certain expenses you can tailor the budget to your family. The example is based on a month because home mortgage payments are usually made monthly. If you have weekly or periodic income and expenses you will find it useful to convert everything to a monthly basis.

After the budget is complete you can begin to determine how much your family can afford for a home. The next step is to estimate utility costs for the size and location of the prospective home, then decide how much money should be set aside each month for repairs and maintenance. Utility costs can be estimated from your past experience (if your present housing is comparable to what you plan to purchase), from the seller's records (if you plan to purchase an occupied home), or from the utility companies serving the area. Maintenance and repair costs will vary considerably depending on the age of the home and of the equipment and appliances in it. If you intend to buy a new home that has a good warranty, it is safe to make a small repair allowance during the first few years. But, if you intend to purchase an older home with older appliances, you will find it necessary to initially set aside a considerably larger monthly amount for expected repairs and maintenance. It is better to set aside too much rather than too little for repairs because the unexpected frequently happens.

Next, get an estimate of property taxes from your county assessor. An insurance agent can provide the insurance cost information you will need. Convert both estimates to monthly figures.

After all of this is done, determine how much monthly income your family can afford for principal and interest payments by subtracting utility costs, repair and maintenance costs, property taxes and insurance costs from the last line on your budget.

As an example, suppose that your family can afford $620 a month for principal and interest payments. Also assume that you have checked with various lenders and found that you would have to pay 12 percent interest (fixed rate) to borrow the money you need to purchase a home. The lender can also tell you from tables that you can finance $60,000 at 12 percent for 30 years for a $617.17 principal and interest payment each month (a higher interest rate would result in a smaller loan with the same monthly payment, while a lower rate would do the opposite). Finally, if you add the amount of downpayment that you can make to the loan amount you will have a well-thought-out estimate of how much your family can

*Extension real estate specialist, The Texas A&M University System.

Texas Agricultural Extension Service • The Texas A&M University System • Zerle L. Carpenter, Director • College Station, Texas

afford to pay for a home.

A variable rate mortgage (VRM) can complicate these calculations. If you finance a home with a mortgage which has monthly payments which might change in future years, your budget will have to adjust to accommodate the changes. This is no problem if the payments decrease, but may become a problem if the payments increase substantially. Of course, everyone hopes his or her income will increase more than the house payment will.

After all of these calculations are made, families may be disappointed that they cannot afford a certain home or one in a specific neighborhood. The family may have to lower its standards or wait until more income or a larger downpayment is available. An alternative is to re-examine the budget to determine if some of the expenses and allowances that were classified as desired can be reduced. For example, some families may be willing to forego vacations if doing so allows them to purchase a home that they really want. There may be some hard choices to make, but at least the budget provides a logical framework within which to make them. It also reduces the possibility of purchasing a home which later becomes an excessive financial burden.

Closing Costs

An additional group of expenses incurred by homeowners are one-time expenses commonly referred to as closing costs (some are actually prepaid expenses). These are the costs of obtaining financing and transferring ownership. Since closing costs can be substantial, often amounting to a few thousand dollars, they reduce the downpayment that can be made.

As a home buyer you can expect to pay at least some, but not necessarily all, of the following: (1) loan origination fee, (2) appraisal fee, (3) credit check cost, (4) title search fee, (5) recording fee and tax, (6) survey charge, (7) points on the loan, (8) prepaid interest, (9) prepaid taxes, (10) a lawyer's fee and (11) various insurance expenses. Although estimates of these costs will be provided by lenders when you apply for a loan, some of them may be negotiable before you sign the purchase agreement with the seller. Allow for these expenses as you decide what you can afford. When added to the actual moving costs (don't overlook utility deposits and so forth), closing costs can be quite large and a shock to your budget.

The Length of a Loan

Home buyers have traditionally taken 30-year mortgages with little consideration to shorter terms. The example used earlier indicated that a 30-year, $60,000 mortgage at 12 percent required monthly payments of $617.17. These payments total $222,180.32 ($60,000 plus $162,180.32 interest) paid over 30 years. If the buyer's budget allowed an increased payment of 14.76 per month (to $631.93), a 12 percent, $60,000 mortgage could be paid in 25 years.

Table 1. Monthly Income and Expenses.

Monthly Income Available*:	________
Necessary Expenditures (excluding housing):	
Food (include eating out)	________
Clothing Allowance	________
Insurance (life and health)	________
Medical and Dental	________
Automobile (payment, repairs, insurance, license, operating costs)	________
Installment Debt Payment(s)	________
Miscellaneous	________
Desired Expenditures and Allowances:	
Savings	________
Entertainment and Recreation	________
Vacation Allowance	________
Donations	________
Pocket Money	________
Education Allowance	________
Total Expenses and Allowances:	________
Amount Available for Shelter (Mortgage payment, utilities, repair and maintenance, taxes and insurance)	________

*The take-home pay of all family members who are contributing (and are expected to continue to contribute) to family expenses, plus income from other sources (interest, dividends, child support and so forth) that the family is able and willing to spend each month. This amount should not include interest or other income that is earmarked for long-term savings.

In this case, payments would total $189,580.32 ($60,000 plus $129,580.35 interest). By increasing the monthly payment by a little less than $15 per month the buyer could save $32,599.97 in interest cost and 5 years of payments (shorter terms result in bigger interest savings). Even though interest payments are tax-deductible, it may be worthwhile for you to consider a mortgage for less than the traditional 30 years. Lenders can provide the information that you need to explore the feasibility of this possibility as you make your decisions.

Conclusion

Home ownership can be very rewarding, but it is costly. To increase the probability that the purchase of a home will not be an excessive financial burden, thoroughly analyze your budget to determine what you can comfortably pay for a home. The process takes some time and can be a bit frustrating, but in the long run you will be more satisfied with your decision. Be familiar with and accommodate the closing costs associated with the purchase of a home, as well as considering the term of the mortgage.

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